Supreme Court, U. S.
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IN THE

# SUPREME COURT OF THE UNITED STATES

October Term, 1978

No. 78-1033

SOUTHLAND ROYALTY COMPANY, *Petitioner*

*v.*

THE UNITED STATES, *Respondent*

## Petition for a Writ of Certiorari to the United States Court of Claims

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IN THE

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SOUTHLAND ROYALTY COMPANY, *Petitioner*

*v.*

THE UNITED STATES, *Respondent*

## Petition for a Writ of Certiorari to the United States Court of Claims

Southland Royalty Company, Petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in the above case on July 14, 1978, and the denial of Petitioner's Motion for Rehearing on September 29, 1978.

### Opinion Below

The opinion of the United States Court of Claims is reported at .....Ct. Cl.....  A copy of the parts of the opinion relevant to this Petition is appended as Appendix B at pages A-5 - A-34.

### Jurisdiction

The judgment of the United States Court of Claims was entered on July 14, 1978, petition for rehearing denied on September 29, 1978. Jurisdiction of this Court is invoked under 28 U.S.C. Section 1255 (1).

## Questions Presented

1. Are the legal expenses incurred by Petitioner in 1967 and 1968 in connection with state court litigation which had its origin in orders of the Texas Railroad Commission that affected the operation and management of oil and gas wells in which Petitioner had interests, currently deductible for federal income tax purposes under Internal Revenue Code Section 162, or must the expenses be capitalized pursuant to Code Section 263?

2. Is the deductibility of litigation expenses to be determined according to the origin or character of the litigation or by reference to the purpose or the "effect" of the remedy sought by the plaintiff in the litigation?

3. In any event, is the determination by the highest court of the state where the litigation arose on issues of state law, e.g. origin or character of the state litigation, binding in federal income tax cases? If the determination of the highest state court is not binding in federal income tax cases, is origin or purpose an issue of fact to be determined by the trial court or an issue of law subject to appellate redetermination?

## Statutes and Regulations Involved

The pertinent portions of Internal Revenue Code of 1954, as amended, Sections 161, 162, 212 and 263, (26 U.S.C. .....), and the related Treasury Regulations are set forth in Appendix A, at pages A-1 - A-4.



## Statement

This case involves a refund action for federal income taxes and assessed interest for the calendar years 1967 and 1968, in the amounts of $12,474.43 and $66,134.79, respectively, or a total of $78,609.22, plus statutory interest from dates of payment. There were three (3) separate issues presented to the Court of Claims, but only one is the subject of this Petition.

With respect to the issue presented in this Petition, litigation expenses totaling $136,791.23 were incurred in 1967 and 1968 by Plaintiff - Petitioner Southland Royalty Company (sometimes hereinafter in this Petition referred to as the "Petitioner"). The litigation involved a suit in the civil courts of the State of Texas. At issue was the construction of the "Waddell lease."

On July 14, 1925, W. N. Waddell and others, as the owners of 45,771 acres of land situated in Crane County, Texas, and commonly known as the "Waddell Ranch," granted an oil and gas lease on such land to Gulf Production Company, corporate predecessor of Gulf Oil Corporation ("Gulf"). As successor to W. N. Waddell and others, Petitioner later became the owner of a fraction of the royalty interest in the Waddell Ranch and, therefore, of a fractional reversionary interest entitling Petitioner to participate in the further development of the minerals, or in the issuance of a new mineral lease on the property, following the expiration of the term of Gulf's oil and gas lease on the property.

The Gulf lease was for a term of 12 years from its date and for as long thereafter as oil or gas was pro-

duced from the land, but the term of the lease was limited by a provision expressly declaring "that this lease shall not remain in force longer than fifty (50) years from this date."

The pertinent provisions of the Waddell lease are quoted:

SECTION 1.

* * *

Par. 2. TO HAVE AND TO HOLD unto said Lessee and to Lessee's successors and assigns for the term of Twelve (12) years from the date hereof and as much longer thereafter as oil or gas (or other minerals, if produced hereunder) are produced from said land. Provided, that this lease shall not remain in force longer than fifty (50) years from this date, and provided further, that a temporary cessation of production due to cleaning out, working over or drilling deeper of any well, or similar causes occurring after production secured, shall not terminate this lease. And Lessor covenants that Lessor has good title to said land and will protect Lessee in the quiet and peaceable possession thereof.

* * *

SECTION 7.

Paragraph 1. When drilling or other operations are delayed or interrupted by storm, flood, or other act of God, by fire, war, rebellion, scarcity of water, insurrection, riots, strikes, scarcity of labor, differences with employees, or failure of carriers to transport or furnish facilities for transportation, or as the result of some order, requisition or necessity of the Government, or as



the result of any cause whatsoever beyond the control of the Lessee, the time of such delay or interruption shall not be counted against the Lessee — anything in this lease to the contrary notwithstanding."

Gulf successfully drilled many oil and gas wells on the Waddell Ranch; and, by 1967, Gulf was operating on that property approximately 900 wells that were producing oil and gas. Petitioner was entitled to (and presumably received) its proportionate share of the royalty payments on the oil and gas produced by such wells.

The Texas Railroad Commission, in the exercise of authority conferred on it by the Texas legislature to make and enforce rules and regulations for the conservation of oil and gas, and to prevent waste of oil and gas ordered production of oil and gas from the wells on the Waddell Ranch to be stopped for 197 days between January 20, 1938, and March 23, 1940. Thereafter, the Commission issued monthly proration orders which restricted the amount of oil and gas that could be produced by Gulf from the wells on the Waddell Ranch. The Railroad Commission orders affected Gulf's operation of the wells and the amounts of income derived by Gulf and Petitioner from those wells.

On or about October 11, 1967, Gulf and others filed suit against Petitioner and others in a district court of the State of Texas, seeking a declaratory judgment to determine the longevity of the oil and gas

lease on the Waddell Ranch. Gulf et al. contended in the litigation that delays in the production of oil and gas from the Waddell Ranch due to proration orders issued by the Texas Railroad Commission should not be counted in determining the date on which the 50-year term of the lease would expire; and that the termination of the lease should not occur until 1987. Petitioner et al, on the other hand, contended that Gulf's leasehold estate would expire on July 14, 1975, which would be exactly 50 years after the date of the execution of the lease.

But for the Railroad Commission orders affecting the operation, management and conservation of the Waddell Ranch property, this litigation would not have arisen. The Railroad Commission has no authority to make or enforce determinations about title to or ownership of property in Texas.

The litigation proceeded through the state district court and the Texas Court of Civil Appeals, each of which rendered judgment in favor of Petitioner et al.; and it was finally concluded by the Texas Supreme Court in a decision dated May 30, 1973 (496 S.W. 2d 547). The Texas Supreme Court affirmed the judgments of the courts below, and declared that Gulf's oil and gas lease on the Waddell Ranch would terminate finally on July 14, 1975.

During 1967 and 1968, Petitioner accrued obligations in the amounts of $22,898.68 and $113,892.55, respectively, representing amounts payable to one law firm in 1967 and to two law firms in 1968 for legal services rendered in connection with the litigation



instituted by Gulf et al. These respective amounts were deducted by Petitioner in computing its federal income taxes for the calendar years 1967 and 1968; the deductions were disallowed by the Internal Revenue Service, which assessed deficiencies; the amounts of the deficiencies, plus interest, were paid by Petitioner and Petitioner has sued for refunds.

Petitioner's ownership of a fraction of the royalty interest in the Waddell Ranch and, therefore, of a fractional reversionary interest had been acquired long before the controversy with Gulf arose over the longevity of the mineral lease. In the litigation, Gulf did not attack Petitioner's entitlement to a fractional royalty interest and related fractional reversionary interest. For that reason, there was no occasion in the litigation for Petitioner's title to an interest in the property either to be defended or perfected.

As the legal issue in the Gulf litigation did not relate to title, but, rather, to the longevity of the oil and gas lease on the land and whether delays in the production of oil and gas from the land attributable to proration orders issued by the Texas Railroad Commission should or should not be counted in determining the date on which the 50-year term of the lease would expire, it was not necessary for Petitioner's 1967 and 1968 legal expenses to be capitalized. Accordingly, such expenses were deductible for income tax purposes under section 162(a) of the 1954 Code as ordinary and necessary business expenses.

The Gulf litigation expenses were ordinary and

necessary business expenses to Petitioner because the expenses were reasonable in amount, common in the oil and gas business, common ("ordinary") in Petitioner's business, and helpful ("necessary") in Petitioner's business.

In the conduct of its business, Petitioner has regularly engaged attorneys to perform legal services for it and to give it legal advice, including, but not limited to, representation in litigation. The legal services and advice received by Petitioner have been necessary and helpful to Petitioner in day-to-day operation and management of its business.

The types of legal services and advice received by Petitioner during 1967 and 1968 were common in the petroleum industry.

The Court of Claims majority opinion in the 2-1 decision adopted the Trial Judge's findings of fact, but disregarded them in reaching its decision. The majority opinion based its decision upon the "dominant factor," or "effect" of the state court litigation.

The majority opinion in this split decision disregarded the origin of the litigation, and erroneously based its judgment upon the "object," or purpose of the litigation. Even if purpose is the correct legal standard to apply, the majority erroneously disregarded the findings of fact by the Trial Judge, to which neither party took any exception, and the specific characterization of the litigation by the highest court of the State.

The majority distinguished on insufficient grounds



the decision by Justice Blackmun in the case of *Industrial Aggregate Co. v. United States*, 284 F.2d 639 (8th Cir. 1960).

The dissenting opinion agreed with the Trial Judge that the Petitioner should prevail on this issue.

## Reasons for Granting the Writ

### I.

**The split decision of the Court below should be reviewed because it conflicts with prior decisions of this Court, of the Courts of Appeal, and erroneously interprets the Internal Revenue Code.**

Internal Revenue Code (hereinafter referred to as the "Code") Section 162 allows a deduction for all ordinary and necessary business expenses incurred in carrying on a trade or business. The legislative history of Code Sections 162 and 212 demonstrates that Petitioner's litigation expenses are currently deductible under Section 162. In the case of *Higgins v. Commissioner*, 312 U.S. 212 (1941), this Court determined that the statutory predecessor to Code Section 162 did not permit individuals to deduct expenses not incurred in a trade or business, even though they were incurred in connection with certain income producing activities. To reverse this ruling, Congress enacted the statutory predecessor to Code Section 212. Section 212 now specifically permits individuals to deduct expenses "for the production or collection of income, and for the management, conservation, or maintenance of property held for the production of income." This language precisely describes the origin (and also the

purpose) of Petitioner's litigation expenses in this case. Code Section 212 does not apply to corporations, but this Court has held that Code Sections 162 and 212 are *in pari materia*. *Bingham's Trust v. Commissioner*, 325 U.S. 365 (1945). Therefore, Code Section 162, applicable to both corporations and individuals, includes the deductions allowed to individuals by Code Section 212. This legislative history and its significance are described in *United States v. Gilmore*, 372 U.S. 39 (1963). The language of Code Section 212 is helpful in interpreting and applying Code Section 162, as are the court decisions interpreting Code Section 212.

Petitioner's Gulf litigation expenses in 1967 and 1968 are precisely described by Code Section 212.

Code Section 263 requires certain expenses to be capitalized, instead of being deducted in the year paid or incurred. Code Section 263 does not apply to the facts of this case, because none of Petitioner's litigation expenses was "an amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate." Even if they are valid,[1] Treasury Regulations Section 1.263 (a)-2(c) do not apply to the facts of this case, because

[1]An alternative position of Petitioner is that Treasury Regulations Section 1.263 (a)-2(c) is an unwarranted extension of the Code. In *Bingham's Trust v. Commissioner*, 325 U.S. 365 (1945), this Court said:

"So far as this regulation [the predecessor to Sec. 1.263(a)-2(c)] purports to deny deduction of litigation expenses unless it is to produce income, it is not in conformity to the statute, . . . . To that extent and to the extent that it departs from the rule of *Kornhauser v. United States*, supra, it conflicts with the meaning and purpose of §23(a)(2), and so is unauthorized."



Petitioner's litigation expenses were not a "cost of defending or perfecting title to property." Since Code Section 263 does not by its own terms apply, this case does not present the question of the interrelationship of Code Sections 162, 212 and 263. The holding by two judges of the Court below is contrary to the intent of Congress as expressed in Code Sections 162 and 212, and should be reviewed and set aside upon hearing.

Furthermore, that the litigation expenses may relate to a time or date in the future does not automatically invoke the rules of Code Section 263, where, as here, no new and distinct asset is acquired. See *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971) ("many expenses concededly deductible have prospective effect beyond the taxable year").

## II.

**This Court should grant certiorari to review the holding of the Court below because it directly conflicts with the "origin" criterion previously established by this Court.**

This Court's decision in *United States v. Gilmore*, supra (fees in a divorce proceeding originate in a personal, nondeductible relationship), established the proper standard for determining if state litigation expenses are currently deductible or must be capitalized to be the *origin* and character of the litigation. This Court specifically rejected the test of the *consequences* of the expenses. This Court extended its *Gilmore* holding in *Woodward v. Commissioner*, 397 U.S. 572 (1970), and *United States v. Hilton Hotels Cor-*

*poration*, 397 U.S. 580 (1970), both of which involved the expense of valuation of stock being acquired. Under these decisions, if the expenses originate or arise in connection with a business or profit-seeking activity, the expenses are deductible under Code Section 162 or 212. If the origin is capital in nature, that is, in connection with the acquisition of property, the expenditure must be capitalized under Code Section 263.

The origin of Petitioner's litigation against Gulf was the Texas Railroad Commission orders affecting the operation and management of the wells affected by those orders. But for these orders, the state litigation would not have occurred. The management and operation activities involved in the litigation occurred in the ordinary course of Petitioner's business, and, therefore, are not capital in nature. The litigation was begun when Gulf sought relief from the effect of the Railroad Commission orders on its business. The form of the action was a suit against Petitioner as defendant for a construction of the Waddell Ranch lease. Gulf did not sue the Railroad Commission, because the Railroad Commission clearly had full power and authority to issue those orders that affected Gulf's business operations and that affected Petitioner's income from the wells. Petitioner defended the suit in the ordinary course of its business of managing and conserving its income-producing properties and the income therefrom. Respondent has asserted that it is error to focus on the origin of the litigation from Gulf's viewpoint, but since Gulf initiated the litigation due to actions of a third party, the origin doctrine seems to require at least an initial inquiry into Gulf's



circumstances. This Court should grant this petition to clarify this important point.

In *Gilmore*, *Woodward*, and *Hilton Hotels Corp.*, supra, this Court related the origin doctrine approach to the activities of the taxpayer in connection with which the claim arose. Under the facts of this case, the "origin" of Petitioner's defense of Gulf's suit (Petitioner's only alternative being to concede) has been proven to be its profit-seeking business activities, such as collection of income from the Waddell Ranch Wells, and management and conservation of those income-producing properties in which Petitioner held a royalty and reversionary interest. These origins of the Gulf litigation are not capital in nature. For these reasons, it should make no difference in the outcome of this case whether the focus on the origin of the litigation is on Gulf or on Petitioner.

The majority of the Court below disregarded the origin of the litigation and decided the case on the basis of the "dominant motive," or purpose, of the litigation. This is an incorrect legal standard that conflicts with this Court's decisions in *Gilmore*, supra, *Woodward*, supra, and *Hilton Hotels Corp.*, supra.

The decision of the Court below demonstrates that the law is still unsettled on a question of federal law that this Court has previously indicated is important by the cited decisions in this area, and continues to be important in the administration of federal income tax law. The increasing amount of state and federal litigation and the expenses incurred therewith makes this unsettled issue significant both as a fiscal matter

(collection of revenue) and as an administrative matter (voluntary compliance with the Internal Revenue laws and manpower to enforce collection). Enormous amounts of time of Internal Revenue Service personnel and lower courts are being taken to resolve the continuing uncertainty on this question. The question should be settled by this Court upon review of this Petition.

## III.

**This Court should grant certiorari to review the decision of the Court below that conflicts with prior decisions of this Court that the decision of the highest Court of the State on state law questions is binding in federal income tax cases.**

The two judges of the Court below disregarded the decision made by the Supreme Court of Texas about the nature and origin of the state court litigation. The Supreme Court of Texas in the case of *Gulf Oil Corporation v. Southland Royalty Company*, 496 S.W. 2d 547 (1975), held that the litigation involved the longevity of a lease, which is not the defense or perfection of title to property.

This characterization of the litigation at issue and determination of state law by the highest court of the state are binding upon the federal court in federal income tax cases. This Court decided in *Bosch v. Commissioner*, 387 U.S. 456 (1967), that a decision by the highest Court of a State is the best authority on that state law, and any such State decision is to be followed by the federal court. The majority opinion



of this Court in the *Bosch* case said as follows:

> "... Thus, under some conditions, federal authority may not be bound even by an intermediate state appellate court ruling. It follows here then, that when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should *a fortiori* not be controlling. This is but an application of the rule of *Erie R. Co. v. Tompkins, supra*, where *state law as announced by the highest court of the State is to be followed.* This is not a diversity case but the same principle may be applied for the same reasons, *viz.*, the underlying substantive rule involved is based on state law and the *State's highest court is the best authority on its own law.*" (Emphasis supplied)

This Court should grant this Petition to apply the *Bosch* rule to the facts of this case, and to consider the important question of the interrelationship of determinations by the highest state court in a federal income tax case.

In the *Woodward* case, supra, this Court said:

> "In one sense, any lawsuit brought against a taxpayer may affect his title to property — money, or other assets subject to lien. The courts, *not* believing that Congress meant *all* litigation expenses to be capitalized, have created the rule that such expenses are capital in nature *only* where the taxpayer's *primary* purpose in incurring them is to defend or perfect title to property." (Emphasis supplied)

This language is especially important to the resolu-

tion of the instant case. First, it makes quite clear that capitalization of expenses for income tax purposes is not required in every case where some title to property may be said to be involved. The findings of the Trial Judge support Petitioner's position in this regard.

Second, the quoted portion of the opinion of this Court in *Woodward*, supra, suggested possible continued vitality of the "purpose" doctrine in "litigation that may affect a taxpayer's title to property more or less indirectly". As stated above, under the facts of this case, that theory does not help Respondent in this case. The Trial Judge of the Court of Claims found, and the Respondent has accepted without exception, the facts to be that Petitioner's purposes in defending Gulf's suit were to permit it to make definitive plans for the operation of the Waddell property upon a confirmation of the July 14, 1975, expiration date and to collect the ordinary income to accrue to its reversionary interest. Collection of this income in specifically within the terms of Treas. Regs. Sec. 1.212-1(k). Gulf's purpose was the same — to prolong its management and operation of the property, and its realization of ordinary income therefrom. There was no capital acquisition purpose, nor any direct dispute over title. At most, as in every suit involving collection of ordinary income from property, as opposed to income from services, the foundation of ownership of the income producing property must first be laid. This foundation was stipulated by Gulf and Petitioner in the state court litigation, that is, Gulf had good title to its interest in the Waddell lease and Petitioner



had good title to the royalty and the reversion under that lease. The parties agreed and admitted that the outcome of the litigation would not be affected by a determination of who owned "title" to the minerals in place. Because this question was not material or relevant in the Gulf litigation, the Texas Supreme Court did not even mention it.

This Court in the recent case of *State of California v. Southland Royalty Company*, ....U.S....., 98 S. Ct....., 56 L. Ed. 505 (1978), also decided that title was not material to the outcome of the case. Therefore, every court to have considered the effect of the relationship and dispute between Gulf and Petitioner, except the Court below, has concluded that title with respect to the Waddell Ranch lease was not determinative of the issue presented.

The question of the length of a lease was the subject of the decision in *Industrial Aggregate Company v. United States*, 284 F.2d 639 (8th Cir. 1960), in an opinion written by Justice Blackmun. The taxpayer, the lessee in that case, incurred legal expenses in the state court litigation that was settled. The income tax issue was similar to the one in this case — whether expenses incurred in connection with a dispute over a gravel lease and the lessee's operations under that lease were non-deductible capital expenses. The Court did not wholly rely on the proposition that no title was involved; rather, it said "that the mere fact that title to property happens to be involved in litigation does not necessarily mean that expenditures of the litigation are automatically rendered non-deductible by the

regulation." Thus, even if Respondent could somehow show that a title question was present in the Gulf litigation (contrary to the Trial Judge's decision, to stipulations in the State litigation about title, and contrary to the parties' recognition and admissions that no title matter could affect the outcome of the litigation), Petitioner is still entitled to prevail on the question of the deductibility of the litigation expenses in view of the undisputed facts concerning the nature, purpose and origin of the Gulf litigation. As Oakland in the *Industrial Aggregate* case, neither Gulf nor Petitioner succeeded in effecting a change whatever in the lease. See footnote 13, *Industrial Aggregate Company*, supra.

As an alternative position, Petitioner submits that, even if the Texas Supreme Court decision is not binding in federal income tax cases, and if a permissible criterion for deciding cases involving title to property indirectly, is the purpose of litigation, the purpose in this case was not primarily to defend or perfect title to property, and Petitioner is entitled to prevail. The determination of purpose is a fact question exclusively within the province of the trier of fact. Upon review, the findings of fact cannot be disregarded, where, as here they are supported by all of the evidence, and none of the evidence is to the contrary. This Court should grant this Petition in order to correct the error of the Court below on the permissible scope of redetermination of fact findings.



## IV.

**This Court should grant this Petition in order to terminate the administrative practice of inconsistent positions in similar matters to the detriment of the voluntary, self assessment tax system.**

This Court below erred in adopting arguments made on behalf of the Internal Revenue Service which are directly contrary to positions taken by the Internal Revenue Service in other litigation. See *Walsh v. United States*, ....F.Supp....., 78-2 U.S. Tax Cas. ¶9615 (D.C.N.D. Tex. 1977). Fair and consistent administration of the income tax laws should guide the Internal Revenue Service and its attorneys, not the maximization of revenue in any particular case. This ambivalence of the Internal Revenue Service creates confusion among taxpayers who try to comply voluntarily with the law. This Court should grant this Petition to establish limitations upon the freedom of the Internal Revenue Service arbitrarily to take inconsistent positions. Such a practice erodes the confidence of the taxpaying public in the present tax system. The practice should be stopped in the interest of the integrity and preservation of the existing voluntary compliance, self-assessment method of revenue collection.

## Conclusion

For the reasons set forth above, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Gordon Appleman

GORDON APPLEMAN

## Proof of Service

I, GORDON APPLEMAN, attorney for Southland Royalty Company, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that, on the 22nd day of December, 1978, I served copies of the foregoing Petition for Writ of Certiorari to the United States Court of Claims on the Respondent, The United States, by mailing a copy in a duly addressed envelope with air mail postage prepaid, to Donald Olson, Esquire, The United States Department of Justice, Washington, D.C. 20530.

Gordon Appleman

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## APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 161. ALLOWANCE OF DEDUCTIONS.

In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In general.* — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

SEC. 212. In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

* * * * *

SEC. 263.

(a) *General Rule.* — No deductions shall be allowed for —

(1) Any amount paid out for new buildings or for permanent improvements or betterments

made to increase the value of any property or estate.

* * * * *

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.212-1 *Nontrade or nonbusiness expenses.*

(a) An expense may be deducted under section 212 only if —

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property.

* * * * *

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering



property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

§ 1.263(a)-1. Capital expenditures; in general. —

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for —

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of prop-

erty owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and §1.162-4.

§ 1.263(a)-2. *Examples of capital expenditures.* — The following paragraphs include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

* * * * *

(c) The cost of defending or perfecting title to property.



## APPENDIX B

IN THE UNITED STATES COURT OF CLAIMS

No. 12-75

(Decided July 14, 1978)

SOUTHLAND ROYALTY COMPANY v. THE UNITED STATES

*Gordon Appleman*, attorney of record for plaintiff. *Bird & Appleman*, of counsel.

*Donald H. Olson*, with whom was *Assistant Attorney General M. Carr Ferguson*, for defendant. *Theodore D. Peyser*, of counsel.

Before COWEN, *Senior Judge*, DAVIS and KUNZIG, *Judges*.

OPINION

DAVIS, *Judge*, delivered the opinion of the court:

This is a corporate income tax dispute whether certain business expenditures should be deducted as ordinary and necessary expenses or should be capitalized. Taxpayer Southland Royalty Company ("Southland") is engaged in the oil and gas business. It keeps its books and reports its income and expenses for federal income tax purposes on the calendar year and accrual bases. The controversy revolves around the deductibility of expenses which Southland accrued during 1966, 1967, and 1968 in connection with litigation, and of expenses which it accrued during 1968 for a

study of petroleum reserves. Senior Trial Judge White concluded that the plaintiff was entitled to take a current deduction for (1) the litigation costs incurred in 1966 in connection with the collection of royalties; (2) unrelated legal expenses incurred in 1967 and 1968 in a separate suit concerning the timing of the reversion of a leasehold; and (3) the costs of preparing the oil reserve survey incurred in 1968 as ordinary and necessary business expenses under I.R.C. § 162(a). In so deciding, the trial judge held that plaintiff was not required to capitalize the various costs pursuant to I.R.C. § 263, as contended by the defendant. We concur with this disposition of the first and third issues, but rule for the defendant on the second.[1]

## I.

Southland contends that each of the three items of expense involved in this suit was deductible for income tax purposes under I.R.C. § 162(a)[2], which provides that:

> (a) *In general.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

I.R.C. § 263(a)(1), on the other hand, declares that:

> (a) *General Rule.* — No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . .

[1] Neither party excepts to the trial judge's findings of fact which we adopt. The issues before us are essentially "legal" problems or "mixed" questions in which the "legal" element predominates.

[2] All references to the Internal Revenue Code are to the provisions as they were in force during the applicable tax years.



It is familiar law that I.R.C. § 263 (if applicable) takes precedence over I.R.C. § 162. I.R.C. §§ 161, 261.[3] *See Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17 (1974). Also, I.R.C. § 263 does not provide a complete list of non-deductible expenditures.[4] *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 358 (1971). Expenditures incurred in the acquisition of a capital asset must generally be capitalized. *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970). "Ordinary," as used in I.R.C. § 162, differentiates between those expenses currently deductible versus those which must be capitalized and amortized over the life of the asset, if they are deductible at all. *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966). An expense satisfies the requirement of being "necessary" within the statute if it is "appropriate and helpful" to "the development of the [taxpayer's]

[3] I.R.C. § 161 provides:

"In computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible)."

I.R.C. § 261 provides:

"In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part."

[4] *In Georator Corp. v. United States*, 485 F.2d 283, 285 (4th Cir. 1973), *cert. denied*, 417 U.S. 945 (1974), the court noted that an expenditure does not have to be described as a capital asset in I.R.C. § 1221 in order to be classified as a capital expenditure.

business." *Tellier, supra*, 383 U.S. at 689; *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

For each of the items in controversy, defendant argues on the basis of the regulations that the expenditure must be capitalized because it was incurred: (1) in defending or perfecting title to property (Treas. Reg. § 1.263(a)-2(c)); (2) in the acquisition of property having a useful life substantially beyond the end of the taxable year (Treas. Reg. § 1.263 (a)-2(a)); and/or (3) in adding to the value of, or substantially prolonging the life of, property owned by the taxpayer (Treas. Reg. § 1.263(a)-1(a)(1), -1(b)).[5] We test the three claimed deductions by these

[5] Treas. Reg. § 1.263(a)-1, T.D. 6313, 1958-2 C.B. 117, reads in pertinent part as follows:

"§ 1.263 (a)-1 CAPITAL EXPENDITURES; IN GENERAL.—(a) Except as otherwise provided in chapter 1 of the Internal Revenue Code of 1954, no deductions shall be allowed for—

"(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . .

. . . .

"(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See sections 162 and § 1.162-4."

Treas. Reg. § 1.263(a)-2 provides (in relevant part):

§ 1.263(a)-2 "EXAMPLES OF CAPITAL EXPENDITURES.—The following paragraphs include examples of capital expenditures:

"(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and similar property having a useful life substantially beyond the taxable year.

. . . .

"(c) The cost of defending or perfecting title to property."



general standards.

II.

Deleted.

III.

*The 1967 and 1968 Litigation Expenses*

On July 14, 1925, W.N. Waddell and others, as the owners of 45,771 acres of land situated in Crane County, Texas, and commonly known as the "Waddell Ranch," granted an oil and gas lease on such land to Gulf Production Company, corporate predecessor of Gulf Oil Corporation ("Gulf"). As successor to W. N. Waddell and others, Southland later became the owner of a fraction of the royalty interest in the Waddell Ranch and, therefore, of a fractional reversionary interest entitling Southland to participate in the further development of the minerals, or in the issuance of a new mineral lease on the property, following the expiration of the term of Gulf's oil and gas lease on the property.

The Gulf lease was for a term of 12 years from its date and for as long thereafter as oil or gas was produced from the land, but the term of the lease was limited by a provision expressly declaring "that this lease shall not remain in force longer than fifty (50) years from this date."

Gulf successfully drilled many oil and gas wells on the Waddell Ranch; and, by 1967, Gulf was operating on that property approximately 900 wells that were producing oil and gas. Southland was entitled to (and

presumably received) its proportionate share of the royalty payments on the oil and gas produced by such wells.

The Texas Railroad Commission, in the exercise of authority conferred on it by the Texas legislature, ordered production of oil and gas from the wells on the Waddell Ranch to be stopped for 197 days between January 20, 1938, and March 23, 1940. Thereafter, the Commission issued monthly proration orders which restricted the amount of oil and gas that could be produced by Gulf from the wells on the Waddell Ranch.

On or about October 11, 1967, Gulf and others filed suit against Southland and others in a district court of the State of Texas, seeking a declaratory judgment to determine the longevity of the oil and gas lease on the Waddell Ranch. Gulf et al. contended in the litigation that delays in the production of oil and gas from the Waddell Ranch due to proration orders issued by the Texas Railroad Commission should not be counted in determining the date on which the 50-year term of the lease would expire; and that the termination of the lease should not occur until 1987. Southland et al., on the other hand, contended that Gulf's leasehold estate would expire on July 14, 1975, which would be exactly 50 years after the date of the execution of the lease.

The litigation proceeded through the state district court and the Texas Court of Civil Appeals, each of which rendered judgment in favor of Southland et al.;



and it was finally concluded by the Texas Supreme Court in a decision dated May 30, 1973 (496 S.W. 2d 547). The Texas Supreme Court affirmed the judgments of the courts below, and declared that Gulf's oil and gas lease on the Waddell Ranch would terminate finally on July 14, 1975.

During 1967 and 1968, Southland accrued obligations in the amounts of $22,898.68 and $113,892.55, respectively, representing amounts payable to one law firm in 1967 and to two law firms in 1968 for legal services rendered in connection with the litigation instituted by Gulf et al. These respective amounts were deducted by Southland in computing its federal income taxes for the calendar years 1967 and 1968; the deductions were disallowed by the Internal Revenue Service, which assessed deficiencies; the amounts of the deficiencies, plus interest, were paid by Southland; and Southland now sues for refunds.

The plaintiff urges, and the trial judge held, that the Gulf litigation did not relate to defense of title, but simply to the "timing" of Southland's receipt of income from the Waddell property.[13] We cannot accept this analysis. To us, the dominant factor is that there was a serious contest between taxpayer and Gulf over the right to the property for the period of some 12 years after 1975. Gulf was asserting the right to have and control the leasehold for almost 12 additional years and to exploit the mineral estate during

[13] Southland characterizes its purpose in defending the Gulf suit as "to permit it to make definitive plans for the operation of the Waddell property upon a confirmation of the July 14, 1975, expiration date and to collect the ordinary income to accrue to its reversionary interest."

that time-span under the provisions of the lease. At the termination of the leasehold, Southland would be free to sell the unencumbered property outright, exploit it in its own right, or enter into a new lease on different, possibly more favorable, terms. There was, however, a substantial cloud on Southland's right to do this in 1975;[14] section 7 of the Waddell lease provided that "When drilling or other operations are delayed or interrupted by . . . or as the result of some order, requisition or necessity of the Government, . . . the time of such delay or interruption shall not be counted against the Lessee . . . ." Southland's "plans for the operation of" and collection of "ordinary income" from the property wholly depended upon whether it could gain complete control over its property interests upon the normal expiration date (1975); to do this it had to demonstrate its legal entitlement

[14] A number of courts have held that any litigation expenses must be capitalized, if they are incurred in the defense or perfection of title, regardless of the substantiality of the adverse claim. *Galewitz v. Commissioner*, 411 F.2d 1374 (2d Cir.), *cert. denied*, 396 U.S. 906 (1969); *Estate of Baier v. Commissioner*, 533 F.2d 117 (3rd Cir. 1976); *Safety Tube Corp. v. Commissioner*, 168 F.2d 787 (6th Cir. 1948); *Schwabacher v. Commissioner*, 132 F.2d 516 (9th Cir. 1942). *But see* the comments of Judge Forrester, dissenting in *Ruoff v. Commissioner*, 30 T.C. 204, 226-27 (1958), *rev'd*, 277 F.2d 222 (3rd Cir. 1960), he took the view that litigation costs should be capitalized only if the title was clouded at the time of acquisition, and the comments of Judge Wisdom, dissenting in *Usry v. Price*, 325 F.2d 657, 660-63 (5th Cir. 1963), against the holding that litigation costs were deductible in a suit that was a "re-hash" of issues in earlier title case; *Zietz v. Commissioner*, 34 T.C. 369, 382 (1960) (deduction allowed for litigation costs incurred in suit "wholly without merit and malicious," since the petitions, which might have raised the title issue if allowed to stand, were dismissed). In this instance the issue in the reversionary interest litigation was substantial, so we need not reach the question of whether litigation costs arising from a frivolous claim need be capitalized.



under the lease agreement for the period after 1975.[15] Gulf's declaratory judgment action was brought in 1967, some eight years before 1975 — no present right to receive or duty to pay royalties was at all involved — and had as it sole object a determination that Gulf could continue as lessee for a long period after 1975. Southland necessarily took the opposite stance.[16] (The litigation was concluded in 1973, two years before the normal expiration date in 1975).

As might be expected, there is no precedent precisely in point, but there are decisions strongly suggesting the capitalization result, and none which (in our view) compels a conclusion favorable to plaintiff. In *Reed v. Commissioner*, *supra*, 55 T.C. 32, the taxpayer, in a prior suit, had attempted to have declared invalid an agreement which gave the defendants the opportunity to purchase a partnership interest owned

[15] In *Farmer v. Commissioner*, 126 F.2d 542, 544 (10th Cir. 1942), the court, in holding that the litigation expenses were incurred to defend title and therefore nondeductible, commented:

> Petitioners did more than litigate the right to receive oil royalty payments. The title to the oil and gas lease under which they received these payments depended upon the title to the land. Without title to the land they had nothing. It was therefore necessary for them to defend and establish the title to the land in order to retain their interest in the oil and gas.

[16] The taxpayer in its 1967 annual report characterized the litigation as involving the question whether it would continue to have a royalty interest in the subject property or whether its interest would be converted in 1975 to a "mineral fee", and promised a "vigorous defense." Parenthetically, we do not regard as decisive that the plaintiff would acquire a "mineral fee" at the expiration of the leasehold. Disputes over much less substantial property rights have been held to fall within the purview of the regulations relating to the defense or perfection of title. *Reed*, *supra*, 55 T.C. 32 (right of first refusal on sale of partnership interest); *Boagni*, *supra*, 59 T.C. 708 (interest in overriding royalties); *Manufacturers Hanover Trust Co.*, *supra*, 160 Ct. Cl. 582, 312 F.2d 785 (trustee's legal title).

by the taxpayer, for the book value of the underlying tangible assets plus ten percent, before the interest could be transferred to anybody else. The Tax Court noted that the right to dispose of property freely was an important attribute of ownership; moreover, the right to income was not then in issue. Since the origin of the suit was directly related to the capital asset underlying the partnership agreement and the income interest was not affected by the attempt to remove the restriction upon the sale of the interest, the litigation expenditures were held to be capital in nature. The Tax Court found (under the origin-of-the-claim test) that the expenses were incurred in perfecting title to property. 55 T.C. at 41. *Cf. Thalhimer Brothers v. Commissioner*, 27 T.C. 733, 739 (1957) (capitalization required of payment made to seller so that land could be acquired at an earlier date than stipulated in sale contract; "possession of property is one of the principle attributes of ownership; and the right to early or immediate possession may affect materially the use, the desirability, and the market value"); *Third National Bank in Nashville v. United States*, 454 F.2d 689 (6th Cir. 1972); *American Spring & Wire Specialty Co. v. Commissioner*, 20 T.C.M. (CCH) 116 (1961) (costs of acquiring leaseholds so that old buildings could be demolished and new ones erected on land subject to leaseholds required to be capitalized). Here, as in those decisions, the "tree," not the "fruit" was directly at stake, and the "gist of the controversy [was] the right to the asset which produced the income." *Safety Tube Corp. v. Commissioner, supra*, 168 F.2d at 790.



Taxpayer, in riposte, stresses three sorts of rulings, none of which seems to us applicable. The first group relates to trust litigation. In *Herman A. Moore Trust v. Commissioner*, 49 T.C. 430 (1968), *acq.* 1968-2 CUM. BULL. 2, a trust sought a deduction under I.R.C. § 212(2) and Treas. Reg. § 1.212-1(i), allowing a deduction for "expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration . . . ." Two of the beneficiaries of the trust had brought suit for the activation of certain trusts in their favor; they argued that under the doctrine of acceleration of estates in remainder the renunciation of interest in some of the assets in the trust by their mother, the life income beneficiary, accelerated their interests. The Tax Court held that the trustee's primary purpose in litigating that suit was not in defending his title to the assets, but to obtain a decision on the timing of the remaindermen's rights as an aid to his administration of the trust.[17] 49 T.C. at 438. The litigation expenses were held deductible; the court's clarification of the time of activation of the remaindermen's interests allowed the trustee to administer the trust properly. That situation differs greatly from the one now before us. The distribution of income

[17] In *Manufacturer's Hanover Trust Co., supra*, 160 Ct. Cl. at 591-92, 312 F.2d at 789-90, we held that the litigation expenses had to be capitalized when the trustee's title to the assets itself was challenged; the court noted that:

> This situation is to be distinguished from that which would arise if a fiduciary sought to deduct expenses incurred in determining which of several potential beneficiaries was entitled to receive trust property. There the fiduciary's title would not be at issue, and it would not be engaged in perfecting or defending title.

and corpus from a trust is an integral part of the management and administration of the trust. *See Bingham v. Commissioner, supra,* 325 U.S. at 374-75; *Manufacturers Hanover Trust Co., supra,* 160 Ct. Cl. at 592, 312 F.2d at 790. For that reason expenses incurred by a trust, in litigation over questions involving the timing of distributions of income and corpus, are from the trust's perspective expenses incurred in its administration and therefore deductible under I.R.C. § 212. The acquisition of complete possession and control over a mineral fee, through reversion at the end of a leasehold, is scarcely to be equated to the normal administration problems of a trust, which by their nature and purpose must be concerned with the timing of distributions of income and corpus.

Plaintiff also invokes *Bliss v. Commissioner,* 57 F.2d 984 (5th Cir. 1932), an early opinion which contains some broad language on the deductibility of expenses incurred to protect the owner's right to undisturbed possession and enjoyment of his property. We read later decisions of the Fifth Circuit as limiting the *Bliss* dictum, at most, to the costs of ejecting a present trespasser or illegal occupant (*see Jones' Estate v. Commissioner,* 127 F.2d 231, 232 (5th Cir. 1942); *Morgan's Estate v. Commissioner,* 332 F.2d 144, 150 (5th Cir. 1964)), and as inapplicable to a suit like Gulf's restricted to a declaration of future rights to property.[18]

[18] *Campbell v. Fields,* 229 F.2d 197 (5th Cir. 1956) and *Southern Natural Gas Co. v. United States,* 188 Ct. Cl. 302, 412 F.2d 1222 (1969), both involved the wholly nontitle issues arising from unitization requirements leading to the more efficient recovery of oil and gas.



Another type of case put forward by taxpayer is exemplified by *Industrial Aggregate Co. v. United States, supra,* 284 F.2d 639 Those are cases in which the prior litigation had mixed objectives — recovery of income or damages currently owed, plus some general defense of title — and in which the court passing on the tax question determined that the recovery of damages or income currently owed was the primary or dominant aim. In *Industrial Aggregate Company, supra,* 284 F.2d at 647-49, the court (per then Circuit Judge Blackmun) concluded, on the basis of that particular record, that the primary purpose of the institution of the original state court litigation, of the taxpayer's defense of it, and of both parties in effecting a settlement, was the resolution of that taxpayer-lessee's alleged violations of the operating covenants of the leases (leading to damages for wrongs already committed and to immediate termination of the leases for breach), and that the taxpayer's consequent right or lack of right to an extension of its leases (which could occur only if it were operating properly) was secondary. In the present case, on the contrary, the Gulf litigation had no issues involving the disposition or amount of current income or any questions of damages then arising by Gulf under its lease, or of damages owed by plaintiff to Gulf. The whole case revolved around the future title to and use of the leased property after 1975; the court fight (lasting from 1967 to 1973) centered on that problem of which company would have "title" to the property (*i.e.* right to control, use, and exploit) during the substantial peri-

od from 1975 to 1987.[19]

As a last resort, taxpayer attacks the validity of the regulation on defense or perfection of title to property, but we consider this regulation so long and so well entrenched that it has become part of income tax law. *See Industrial Aggregate Co. v. United States*, *supra*, 284 F.2d at 644, note 7, and Parts I and II of this opinion, *supra*.

IV.

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COWEN, *Senior Judge*, concurring in part and dissenting in part:

I concur fully in Part II and Part IV of the court's opinion but I respectfully dissent from the holding in Part III, which involves the 1967 and 1968 litigation expenses incurred by Southland in the suit filed by the Gulf Oil Company. I would adopt the opinion of the trial judge, for in my opinion, he correctly held that:

> Southland's ownership of a fraction of the royalty interest in the Waddell Ranch — and, therefore, of a fractional reversionary interest entitling

[19] In *Cruttenden v. Commissioner*, 70 T.C. No. 18 (May 8, 1978)—cited by plaintiff as a decision in which legal fees paid to facilitate the return of property (securities) were held deductible—there was no hint of a challenge to any title or legal interests of those taxpayers (the Cruttendens) but merely a failure, for economic and financial reasons, to return the property on time. Moreover, the Cruttendens sought recovery of property to which they claimed an immediate, present right of possession—not a future right.



> Southland to participate in the further development of the minerals, or in the issuance of a new mineral lease on the property, following the expiration of the mineral lease on the ranch—had been acquired long before the controversy with Gulf arose over the longevity of the mineral lease. In the litigation, Gulf did not attack Southland's entitlement to a fractional royalty interest and related fractional reversionary interest. For that reason, there was no occasion in the litigation for Southland's title to an interest in the property either to be defended or perfected.

The question for decision cannot be answered by a general discussion of the elements of a capital expenditure. The defendant has promulgated regulations which were expressly intended to cover the situation involved in this case, and our task is to decide whether plaintiff's right to the deductions is precluded by Treas. Reg. 1.263(a)-2(a), which provides that the cost of acquisition of property having a useful life substantially beyond the taxable year is a capital expenditure, and Treas. Regs. 1.212-1(k) and 1.263(a)-2(c), which state that expenses incurred in defending or perfecting title to property are capital expenditures.

Admittedly, "the line of demarcation between 'an ordinary and necessary expense' as a deductible item and an expenditure incurred in defense of title to property and therefore not deductible is extremely narrow."[1] I agree with the majority that there is no precedent precisely in point, but I differ with the court

[1] *Rassenfoss v. Commissioner*, 158 F.2d 764, 766 (7th Cir. 1946).

in its conclusion that the decisions cited by it strongly suggest the capitalization result. On the contrary, as I read them, all of the cases cited by the majority in support of its view directly and specifically involve costs incurred in acquiring property or in defending or perfecting title thereto. *Farmer v. Commissioner*, 126 F.2d 542, 544 (10th Cir. 1942), is a classic example of a situation in which the claimed expenses were incurred to defend and establish title to land. This is made plain by the following statement from the court's decision:

> * * * The plaintiffs in each suit attacked the lessor's *title* to the land and claimed an interest in the oil and gas that petitioners were receiving under their assignment of the lessor's interest. The suits were defended and the claims of the plaintiff were held to be groundless, and petitioners' *title was established.* Petitioners' total cost of resisting this litigation was $10,804. They sought to deduct this amount as an ordinary business expense and have appealed from a decision disallowing the claim. [Emphasis supplied.]

The following quotation from *Reed v. Commissioner*, 55 T.C. 32, 40 (1970) demonstrates that this was a clear case of expenses incurred in the acquisition of title to property:

> In our view the Supreme Court's holding in *Woodward* [*v. Commissioner*, 397 U.S. 572, 575 (1970)], requires us to apply the origin-of-the-claim test to the expenses arising out of the first cause of action in *Reed v. Robilio* [248 F.Supp. 602 (W.D. Tenn. 1965)]. This, in turn, requires a decision for the respondent. In that first cause of action the petitioners were attempting to obtain *title* to the 30.66-percent interest in R & C. The complaint filed on behalf of Martha [Reed] with the District Court sought an order of reconveyance. It is manifest that this would require a *conveyance of title* to the interest. Not only was "the origin of the claim litigated * * * in the process of acquisition itself," but the litigation was a direct attempt to *acquire*. *Woodward v. Commissioner*, *supra*, at 577. [Emphasis supplied.]



*Thalhimer Brothers, Inc. v. Commissioner*, 27 T.C. 733, 739 (1957), is a case involving the purchase price of a capital asset. It is another title acquisition case and was specifically so labeled by the Tax Court in its statement:

> The second issue is whether petitioner is entitled to deduct, as a business expense, the amount of $25,000 which it *paid* to the sellers of real estate, *in order to obtain title* and possession at an earlier date than had been provided in the purchase contract. [Emphasis supplied.]

In *Third National Bank in Nashville v. United States*, 454 F.2d 689 (6th Cir. 1972), the taxpayer, after unsuccessful negotiations for an outright purchase of property in Nashville, entered into a 25-year lease agreement granting it an option to purchase the property, plus the right to demolish existing buildings and to construct new buildings on the site. When the lease agreement was executed, there were three existing leases on the property. The taxpayer expended funds to procure the early termination of the three leases and then erected a new building on the site. The only issue before the court in that case was

whether the taxpayer's expenditures were allocable to the new building or to the land as a part of the basis. The court held that the costs paid for terminating the leases were allocable to the new building. Obviously, this is just another case where the taxpayer claimed deductions for amounts expended to acquire or perfect title to property.

*American Spring Wire Specialty Co. v. Commissioner*, 20 T.C.M. 116 (1961), primarily involved the acquisition of title to the property which the taxpayer had not previously owned. There the taxpayer attempted to purchase certain improved property adjoining its plant. The owner refused to sell but did agree to exchange it for other property. The taxpayer purchased the other property for $60,000 and exchanged it with the owner of the improved property it wished to acquire.

In contrast to the foregoing cases, in all of which the primary issue was the acquisition or defense of title to property, there are a number of decisions in which the facts are more similar to those in the case at bar. I view them as controlling the issue in favor of the taxpayer.

In *Bliss v. Commissioner*, 57 F.2d 984 (5th Cir 1932), the taxpayer prevailed in a case in which the facts were not nearly as favorable to it as the facts supporting Southland's claim. There the taxpayer had acquired land in Louisiana on which adverse claims were asserted to oil and gas rights by one who had entered on some of the lands and proceeded to drill



oil wells thereon. The taxpayer entered into agreements with two oil companies, which agreed to pay the taxpayer cash, plus other consideration, for oil and gas leases "when the lessor's title to the entire tract of land and to the oil, gas and other minerals thereunder had been perfected and the adverse claims of all parties thereto cancelled and removed." Lawyers were employed by the taxpayer to bring ejectment actions against the adverse claimant of the oil and gas mineral rights. The Supreme Court of Louisiana determined that the adverse claims were invalid. In holding that the attorney's fees expended by the taxpayer in the ejectment suits were deductible as ordinary and necessary expenses, the Fifth Circuit declared:

> * * * The defendants in those suits set up claims, not to title to lands admitted to be owned by the firm, but to rights to minerals therein or extracted therefrom. What was adversely claimed was part of what was or might be produced from the lands when used in business by the firm or its lessees. To treat as an addition to the cost of land the amount of an expenditure made, after ownership was acquired, to enable the owner, his agent or lessee, to possess and use the land for business purposes, undisturbed by intruders or trespassers, would involve a disregard of the difference between the cost of acquiring ownership of property and expenses paid or incurred to protect the owner's right to undisturbed possession and enjoyment of his property, and what it yields or produces, by himself, his agents or lessees. It seems reasonable to treat amounts expended for services rendered in ejecting or excluding trespassers after ownership

has been acquired as expenses incident to the ownership of property and the acquisition and enjoyment of income from it, rather than as additions to the capital investment in the property. * * *[2] [57 F.2d at 985.]

In *Tucker v. Commissioner*, 9 T.C.M. 956 (1950), a closely analogous case, the Tax Court reached the same result as in *Bliss*. The taxpayer successfully prosecuted an ejectment suit against a lessee and obtained possession of a leased farm. The court held that the attorney's fee paid for the prosecution of the suit was deductible from taxpayer's income.

The case of *Herman A. Moore Trust v. Commissioner*, 49 T.C. 430 (1968), involved facts which are more similar to those before us than the facts in any of the decisions relied on by the majority. The *Moore* case is particularly pertinent because of the Government's contention that Southland's title to its reversionary interest in the leasehold was the subject of the dispute in the Gulf litigation and therefore, that plaintiff incurred the attorney's fees in defense of its title. Twelve years after the establishment of the trust involved in the *Moore* case, testator's widow renounced her interest in a portion of the trust assets. The action which gave rise to the tax deductions was a suit brought by the testator's two children in which they unsuccessfully contended that the release and renunciation by the widow acted to accelerate their

[2] Although the majority asserts that the holding in the *Bliss* case has been sharply limited, a subsequent decision of the Fifth Circuit, *Campbell v. Fields*, 229 F.2d 197 (5th Cir. 1956), quotes at length from the *Bliss* case and states that it was not overruled by *Jones Estate v. Commissioner*, 127 F.2d 231 (5th Cir. 1942).



beneficial remainder interest in the renounced property and that the trustee should hold the property and administer the trust as if the widow had died. Here Gulf unsuccessfully contended in the Texas courts that the action of the Texas Railroad Commission prolonged its interest in the leased property and that Gulf should retain its interest and continue as lessee beyond the expiration of the lease. The *Moore* court held that although title was incidentally involved, the trustee's primary purpose in defending his title to the assets was to obtain a decision on the timing of the remainderman's rights. The answer to this question was vital to the trustee's administration of the trust and the Tax Court allowed the deduction. Here, even though title was incidentally involved in the litigation, the real question between Gulf and Southland was one of timing—whether plaintiff's interest would take effect in 1975, as it contended or at a later time, as Gulf contended. The answer to this question was vital to Southland's operation of the properties in order to aid it in the management thereof for the production of income. The trial judge correctly held that the legal issue in the Gulf litigation was "the longevity of the oil and gas lease on the land and whether delays in the production of oil and gas from the land attributable to proration orders issued by the Texas Railroad Commission should or should not be counted in determining the date on which the 50-year term of the lease would expire." The Government does not challenge this determination of the trial judge. Thus, even though title was incidentally involved, I think

that the cases I have cited strongly support a holding that it was not the primary purpose of plaintiff's defense to Gulf's suit to defend or perfect plaintiff's title. Therefore, I think that plaintiff's claim for refund falls within the rule stated by the court in *Industrial Aggregate Company v. United States*, 284 F.2d 639, 645, 647 (8th Cir. 1960).

> * * * On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses. * * *
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>
> Thus * * * the *primary* purpose of Oakland's [lessor's] institution of the state court litigation, of the taxpayer's [lessee's] defense of it, and of both parties in effecting the settlement, was one and the same, namely, the resolution of the issue of the taxpayer-lessee's alleged violations of the operating covenants of the four leases. That the determination of this issue involved the taxpayer's consequent right, or lack of right, to the extension, and thus involved continuing title to the leaseholds as extended, does not make this purpose any less primary.

From the facts found by the trial judge and accepted by both parties, it seems clear to me that plaintiff's primary purpose in defending the suit brought by Gulf was, as stated by plaintiff, "to permit it to make definitive plans for the operation of the Waddell property upon a confirmation of the July 14, 1975, expiration date and to collect the ordinary income to



accrue to its reversionary interest."[3]

In the Texas litigation, there was no dispute over title and therefore it was not necessary for plaintiff either to defend or perfect its title to the land. Obviously, there was no capital acquisition resulting from the litigation. Consequently, I would hold as did the trial judge that plaintiff's 1967 and 1968 legal expenses were deductible for income tax purposes under section 162(a) of the 1954 Code, as ordinary and necessary business expenses.

## FINDINGS OF FACT

The court, having considered the evidence, the decision and findings of Senior Trial Judge Mastin G. White, and the briefs and arguments of counsel, makes findings of fact as follows:

### *General*

1. (a) This is an action to recover federal income taxes and assessed interest allegedly overpaid by plaintiff for the calendar years 1966, 1967, and 1968 in the amounts of $44,067.38, $12,747.43, and $84,308.40, respectively, or a total of $141,123.21, plus statutory interest from dates of payment.

(b) The case involves the deductibility for income tax purposes of:

(1) Legal expenses in the amount of $75,276.18 which plaintiff accrued during 1966 in connection with certain litigation in the state courts of Texas and related settlement proceedings (see findings 9-14);

(2) Legal expenses in the amounts of $22,898,68

[3] Plaintiff's moving brief at p. 35.

and $113,892.55 which plaintiff accrued during 1967 and 1968, respectively, in connection with other litigation in the state courts of Texas (see findings 15-17); and

(3) Expenses in the amount of $31,297.27 which plaintiff accrued during 1968 in connection with the conduct of a study regarding the petroleum reserves in a certain property known as the Waddell Ranch (see findings 18 and 19).

2. Plaintiff keeps its books and reports its income and expenses for federal income tax purposes on the accrual method and on the calendar year.

3. The court has jurisdiction of this case under 28 U.S.C. § 1491.

4. Plaintiff, Southland Royalty Company (usually referred to hereafter in the findings as "Southland"), was, and is, a Delaware corporation, incorporated in 1924. Its principal office was, and is, at Fort Worth, Tarrant County, Texas.

5. (a) Southland is engaged in the oil and gas business. At the times pertinent to this litigation, Southland owned, among other assets used in its business, various interests in many mineral properties in Texas, in other States of the United States, and in Canada. Its interests included fee interests, leasehold interests, royalty interests, and overriding royalty interests. It owned some of these interests alone and others as coowner with other persons, including individuals and corporations.

(b) Southland explored for, produced, and developed oil and gas, and participated in gasoline plant operations and in secondary recovery projects.

(c) Southland earned income from the production and sale of oil, gas, and other minerals from the



properties in which it owned interests.

6. In order to earn its income from the production and sale of oil, gas, and other minerals, and properly to report the correct amount of its income and expenses for income tax purposes and for management, financial, regulatory, and other purposes, Southland maintains — and maintained in 1966, 1967, and 1968 — extensive records of its interests in the properties mentioned in previous findings, of the amount of income attributable to Southland's interest in each property, of the expenses (both operating and other) incurred and paid on each property, and the amount of expense attributable to Southland's interest in each property.

7. (a) Legal, petroleum engineering, accounting, and other questions arise in the regular course of Southland's business, and are resolved. Such questions arose in 1966, 1967, and 1968, and were resolved.

(b) Southland employs and contracts with — and employed and contracted with in 1966, 1967, and 1968 — qualified and skilled persons to obtain the legal, engineering, accounting, and other services necessary for the conduct of the activities mentioned in paragraph (a) of this finding.

(c) Activities of the sort described in paragraphs (a) and (b) of this finding are — and they were in 1966, 1967, and 1968 — common in the petroleum industry, of which Southland is, and was, a member.

8. (a) In the conduct of its business, Southland has regularly engaged attorneys to perform legal services for it and to give it legal advice, including, but not limited to, representation in litigation. The legal services and advice received by Southland have been

necessary and helpful to Southland in the day-to-day operation and management of its business.

(b) The types of legal services and advice received by Southland during 1966, 1967, and 1968 were common in the oil and gas business, and were similar to legal services and advice received by others who were also in the oil and gas business.

*The 1966 Legal Expenses*

Deleted.

*The 1967 and 1968 Legal Expenses*

15. (a) On July 14, 1925, W. N. Waddell and others as the owners of 45,771 acres of land situated in Crane County, Texas, and commonly known as the "Waddell Ranch," granted an oil and gas lease on such land to Gulf Production Company, corporate predecessor of Gulf Oil Corporation ("Gulf"). The lease was for a term of 12 years from its date and as long thereafter as oil or gas was produced from the land, but the term of the lease was limited by a provision expressly declaring "that this lease shall not remain in force longer than fifty (50) years from this date."

(b) As successor to W. N. Waddell and others, Southland later became the owner of a fraction of the royalty interest in the Waddell Ranch and, therefore, of a fractional reversionary interest entitling Southland to participate in the further development of the minerals, or in the issuance of a new mineral lease, upon the expiration of the lease dated July 14, 1925.

(c) Gulf, as the lessee under the oil and gas lease mentioned in paragraph (a) of this finding, drilled, completed, and operated oil and gas wells under such lease. By 1967, Gulf was operating on the Waddell



Ranch approximately 900 wells that were producing oil and gas. Southland was entitled to (and presumably received) its proportionate share of the royalty payments on the oil and gas produced by such wells.

(d) After 1925, the Texas Railroad Commission issued numerous orders which affected the amount of oil and gas, and the number of days, that Gulf could produce from the wells mentioned in paragraph (c) of this finding. The Texas Railroad Commission is the regulatory authority created by the legislature of the State of Texas, pursuant to the state constitution, to make and enforce rules and regulations for the conservation of oil and gas, and to prevent waste of oil and gas. The Texas Railroad Commission was granted this authority following the overproduction of petroleum in the State of Texas and elsewhere in the United States, and in view of the unfavorable economic conditions at that time.

(e) The Texas Railroad Commission ordered production of oil and gas from the Waddell Ranch to be stopped for 197 days between January 20, 1938, and March 23, 1940. Thereafter, the Commission's monthly orders permitted production by most of the oil wells on the ranch of their daily allowable volume, assumed to be that amount produced at the most efficient rate for only a specified number of days of the month. The operator was given the choice of producing each well for the specified number of days in the month or of reducing the rate of production to corresponding percentages so as to achieve the same total production for the month.

(f) On or about October 11, 1967, Gulf and others filed suit against Southland and others in a district court of the State of Texas, seeking a declaratory judgment to determine the longevity of the oil

and gas lease on the Waddell Ranch. Gulf et al. contended that delays in the production of oil and gas from the Waddell Ranch due to proration orders issued by the Texas Railroad Commission should not be counted in determining the date on which the 50-year term of the lease would expire, and that the termination of the lease should not occur until 1987. Southland et al., on the other hand, contended that Gulf's leasehold estate would expire on July 14, 1975, which would be exactly 50 years after the date of the execution of the lease.

(g) On or about November 27, 1970, the state district court entered its judgment, granting a motion for an instructed verdict in favor of Southland et al.

(h) The Texas Court of Civil Appeals, by a decision and opinion dated March 15, 1972, affirmed the judgment of the district court.

(i) Gulf et al. next took the case to the Texas Supreme Court. That court, by means of a decision and opinion dated May 30, 1973 (and officially reported at 496 S.W. 2d 547), affirmed the judgments of the courts below, and declared that the oil and gas lease on the Waddell Ranch would terminate finally on July 14, 1975.

16. (a) During 1967, Southland accrued an obligation in the amount of $22,898.68, representing expenses payable to the law firm of Hudson, Keltner, Smith and Cunningham. This was the amount of the law firm's fee and reimbursable expenses (including court and other related costs, travel, telephone, reproduction of documents, legal research, and postage) for the law firm's services in the litigation referred to in finding 15. All of the $22,898.68 was paid during 1967 or in January 1968, and was a reasonable amount for the services rendered.



(b) Southland deducted the $22,898.68 in computing its federal income tax for the calendar year 1967. Upon examination of such income tax return, the Internal Revenue Service disallowed the total amount of the deduction, determining that the litigation expenses should be capitalized. Following exhaustion of the administrative appeal, the IRS assessed additional income tax and interest thereon against Southland. The income tax so assessed was in the amount of $10,991.37 and the interest thereon was in the amount of $1,756.06, or a total of $12,747.43. Southland paid the $12,747.43 to defendant on December 4, 1970.

17. (a) During 1968, Southland accrued obligations in the total amount of $113,892.55, representing expenses payable to the law firm of Hudson, Keltner, Smith and Cunningham and to the law firm of Stubbeman, McRae, Sealy and Laughlin. The $113,892.55 included the amounts of the law firms' fees and reimbursable expense (including court and other related costs, travel, telephone, reproduction of documents, legal research, and postage) for the law firms' services in connection with the litigation referred to in finding 15. All of the $113,892.55 was paid during 1968 or in January 1969, and was a reasonable amount for the services rendered.

(b) Southland deducted the $113,892.55 in computing its federal income tax for the calendar year 1968. Upon examination of the income tax return, the Internal Revenue Service disallowed the total amount of the deduction, determining that the litigation expenses should be capitalized. Following exhaustion of the administrative appeal, the IRS assessed additional income tax and interest thereon against Southland. The income tax so assessed (and attributable to the Gulf litigation issue) was in the amount of $60,135.27,

and the interest thereon was in the amount of $5,999.52, or a total of $66,134.79. Southland paid the $66,134.79 to defendant on December 14, 1970.

*The 1968 Reserve Study Expenses*

Deleted.

*The Claims*

20. (a) On or about March 15, 1972, Southland duly and timely filed with defendant claims for refunds of all the taxes and interest for 1966, 1967, and 1968 referred to in these findings. Defendant rejected all the claims by letters dated January 26, 1973, notices of which were duly mailed by defendant to Southland by certified mail on January 26, 1973.

(b) No part of the income taxes and interest so paid and claimed has ever been refunded, credited, or otherwise allowed to Southland.

21. Southland is the only person interested in the claims on which this suit is based. No assignment or transfer of any such claim, or any part thereof, or interest thereon, has been made.

## CONCLUSION OF LAW

Upon the foregoing opinion and findings, the court concludes as a matter of law that the plaintiff is entitled to recover as provided in the opinion, together with interest as provided by law, and judgment is entered to that effect. The case is remanded to the Trial Division for a determination of the amount of plaintiff's recovery, under Rule 131(c).